

**ACCOUNTING METHODS
ALLOWED FARMERS:
Tax Incentives and Consequences**

Historic, archived document

Do not assume content reflects current scientific knowledge, policies, or practices.

ABSTRACT

Farmers are allowed to choose between the cash and accrual methods of accounting in reporting income for income tax purposes. In 1969, about 98 percent of farmers used the cash method. However, persons with large nonfarm incomes investing in farm enterprises have used cash accounting to show artificial farm losses for tax purposes. This practice has raised the possibility that the cash accounting option may be restricted or even revoked in the years ahead. This publication discusses the current use of cash and accrual accounting, and the advantages of each. Accounting under the accrual system is explained and inherent difficulties are discussed.

Keywords: Accounting methods, cash accounting, accrual accounting, tax management.

CONTENTS

Summary	iv
Introduction	1
Nonfarm Users of the Liberal Accounting Rules Allowed Farmers	2
Farmers' Use of Cash and Accrual Accounting	8
General Comparison of Cash Versus Accrual Accounting	8
The Cash Method	11
The Accrual Method	11
Comparison of Methods	12
Specifics of the Accrual Method	12
The Physical Count	12
The Inventory Valuation	13
Specific Accounting Procedures Under the Accrual Method	14
Nondepreciable Assets Purchased for Resale	14
Assets Raised and Held Primarily for Sale or Use in the Business	14
Assets Purchased and Held for Draft, Breeding, Dairy, and Sporting Purposes	14
Assets Raised and Held for Draft, Breeding, Dairy, and Sporting Purposes	15
Other Depreciable Assets Acquired for Use in the Business	15
Changing Accounting Methods	15
Effects on Farmers of Changing to Accrual Accounting	17

SUMMARY

Liberal accounting rules allowed farmers under the cash accounting method have provided incentives for high-income nonfarm taxpayers to use agricultural investments to shelter their nonfarm income from tax. The cash accounting option--in effect since 1915--is intended to simplify farmers' accounting tasks for income reporting purposes; nonfarm firms producing and selling merchandise must generally use accrual accounting. Benefits of cash accounting include converting ordinary income into capital gains, delaying the payment of tax for 1 or more years, and reducing tax through "do-it-yourself" averaging. In 1969, 97.7 percent of individuals who filed farm tax returns used the cash method. Returns of the 2.3 percent who used the accrual method accounted for only 7.5 percent of total farm business receipts.

Nonfarm investors using agricultural investments as tax shelters provide both benefits and problems for farmers. Their investments have made additional capital available to some farmers; without cash accounting, the incentive for these investments would largely disappear. On the other hand, the activity of nonfarmers in farm operations increases the competition for farm resources and can potentially cause a distortion of the farm economy.

There is now a possibility that the cash accounting option could be revoked for farmers, either in total or in part, because of its inability to accurately reflect yearly income and because of its use by nonfarm investors in providing agricultural tax shelters. Should farmers be required to shift from cash to accrual accounting, there would be, in many cases, an increased tax obligation in the year of the change. The increased reportable income due to the shift could be spread in equal installments over 10 years, as is done now by farmers who choose to shift to accrual accounting.

In comparison with cash accounting, the accrual method has some disadvantages for the farmer. Use of the accrual system causes farmers to lose (1) some of the favorable capital gain treatment that cash accounting gives raised capital assets, (2) some of the ability to delay tax on the increase in value of certain assets, (3) some of the flexibility of adjusting incomes and expenses for the year, and (4) some of the ease of accounting for tax purposes.

However, farmers using the accrual method of accounting are still allowed certain liberal accounting rules prohibited to nonfarm businesses. There are two additional inventory valuation methods available to the farmer which make the farm accrual accounting procedure less difficult than for many nonfarm firms. And even under accrual accounting, farmers are allowed to deduct current expenses for livestock in the capital account, but postpone the reporting of income until the livestock are sold. This is a major benefit to taxpayers desiring to delay the payment of income taxes.

ACCOUNTING METHODS ALLOWED FARMERS:
TAX INCENTIVES AND CONSEQUENCES

by

Viriden L. Harrison, Agricultural Economist
Farm Production Economics Division
Economic Research Service

INTRODUCTION

The purpose of this publication is fourfold: To compare and discuss the cash and accrual methods of accounting available to farmers; to discuss the reasons why most farmers currently use the cash method; to discuss the attributes of the farm accounting methods which provide incentives for nonfarm investments in agriculture; and to indicate some of the consequences if the cash method were revoked.

As a general rule, U.S. businesses involved with production or sale of merchandise are required to maintain inventories for tax purposes. Deduction of costs for items included in inventory must be deferred until the year in which the goods to which these costs relate are sold. If inventories are necessary to reflect income correctly, only the accrual method of accounting may be used for purchases or sales. 1/

Farmers, however, are excepted from these rules. Even in cases where inventories are a material factor in the production of income, farmers have historically been permitted to use the cash accounting method, which ignores year-end inventories of such items as crops, cattle, feed, and supplies. This makes it possible for expenditures to be deducted in a year prior to the year in which assets produced by these expenditures are sold.

Even under the accrual method, which involves inventories, farmers are permitted to deduct production costs in the year incurred rather than deferring them until the item for which the costs were incurred is sold. However, part of these costs may be offset by an increase in inventory value. For farms under the accrual method, unlike many nonfarm businesses, separate computation for costs for each item of goods sold is not required. 2/ This feature of accrual

1/ Internal Revenue Service, "Tax Guide for Small Business, 1973 Ed.," Pub. 334, pp. 16 and 69.

2/ However, at inventory time, under the accrual method, costs of goods must be determined if the "cost" or "lower of cost or market" methods of inventory valuation are used. Two other inventory valuation methods (discussed later in this report) which do not require computations of costs for goods in inventory are available to farmers.

accounting allowed to farmers greatly simplifies bookkeeping requirements. 3/

Farmers are also permitted other liberal accounting rules. For instance, in most nonfarm businesses, the cost of developing an asset is a capital expenditure and may not be deducted as incurred. This cost may be recovered by depreciation (when appropriate) over the useful life of the asset and at its sale. Farmers, however, have been permitted to deduct certain of the development costs as they are incurred. For example, fruit and nut groves and vineyards may not bear a commercial crop for several years after planting. Yet, except for citrus and almonds, a farmer can elect to deduct as incurred most of the costs (after planting) in developing the enterprise to its productive state, even though such expenditures are capital in nature. Similarly, expenditures associated with raising livestock held for breeding can be deducted as incurred, even though these qualify as capital assets.

The Supreme Court noted that the cash method of accounting was "an historical concession by the [Treasury] Secretary and the Commissioner [of Internal Revenue] to provide a unitary and expedient bookkeeping system for farmers and ranchers in need of a simplified accounting procedure." 4/ The Treasury Department stated that "These liberal deviations from good accounting practices were permitted for farm operations in order to spare the ordinary farmer the bookkeeping chores associated with inventories and accrual accounting." 5/

NONFARM USERS OF THE LIBERAL ACCOUNTING RULES ALLOWED FARMERS

The special accounting rules granted farmers have made investments in farming enterprises attractive to nonfarmers, particularly those in high income-tax brackets. By using the special farm accounting rules which allow deductions of costs before the income resulting from those costs is realized, it is possible to show farm losses for tax purposes which are not true economic losses. These "tax losses" are then used to reduce the investor's total taxable income, which results in a tax savings in an amount depending on his marginal tax bracket. Often, these tax losses arise from deductions taken because of capital or inventory costs, and thus represent an investment in farm assets rather than an ordinary business expense. When capital assets are sold, they are taxed at special capital gain rates. Thus, deductions may be set off against ordinary income while part of the gain from sales of the resulting assets may represent capital gain. 6/

A simplified example will illustrate the use of farm deductions to shelter nonfarm incomes from tax. Assume a 70-percent bracket nonfarm investor invests

3/ A good treatment of farm accounting rules can be found in John C. O'Byrne, *Farm Income Tax Manual*, 3rd. ed., The Allen Smith Co., Indianapolis, Ind., 1964.

4/ *United States v. Catto*, 383 U.S. 102, 116 (1966).

5/ *Tax Reform Studies and Proposals*: U.S. Treasury Dept., pts. 1-3, Committee Print, 91st Cong., 1st sess., Feb. 5, 1969, p. 153. Also, it should be pointed out that the special accounting rules allowed farmers were not expressly authorized by legislation, but were allowed under administrative ruling by the Treasury Department.

6/ *Ibid.*

\$12,000 in a beef breeding herd, expands the herd by keeping heifers, and sells out after 4-1/2 years. The following figures show his net returns from the investment:

Assumptions:

Purchase price for 50 bred heifers, @ \$240	\$12,000
All operating and raising expenses (4-1/2 years)	38,000
Depreciation claimed	6,000
Sales: Breeding stock (126 cows)	30,000
Young stock not held 2 years (230 head)	42,000
Interest or opportunity cost for original capital investment (\$12,000 x .06 x 4-1/2 years)	3,240

Calculations:

Basis (purchase price less depreciation) or (\$12,000 - \$6,000)	6,000
Capital gain (sales price less basis less depreciation recapture) or (\$30,000 - \$6,000 - \$6,000)	18,000
Ordinary income (sales of young stock plus depreciation recapture) or (\$42,000 + \$6,000)	48,000
Tax on capital gain (\$18,000 x .25)	4,500
Tax on ordinary income (\$48,000 x .70)	33,600
Total taxes paid	38,100

Economic profit before taxes (sales less purchase and operating costs less interest on owned investment) or (\$72,000 - \$12,000 - \$38,000 - \$3,240)	18,760
Economic profit after taxes (\$18,760 - \$38,100)	-19,340

Taxes saved on nonfarm income (operating expenses plus depreciation) or (\$38,000 + \$6,000) x .70	30,800
Net or "tax" profit (-\$19,340 + \$30,800)	11,460

By using farm deductions to offset nonfarm income and by converting a portion of his ordinary income into capital gains, the investor has saved \$30,800 in income taxes. Thus, taking account of the taxes saved in this situation, the investor would realize a \$11,460 tax profit on an operation which showed a \$19,340 economic loss.

In addition to the possible realization of a tax profit, the cash accounting rule provides two other possible benefits to the taxpayer--tax delay and reduction in overall tax by "do-it-yourself" averaging. Taxes on nonfarm income may be delayed by deducting farm expenses in a year prior to the year of receipt of income from those expenses. In the above example, by offsetting part of his nonfarm income with farm expenses, the investor was able to delay paying taxes on part of his nonfarm income until the year in which he paid taxes on the sale of the livestock. This provided, in effect, an interest-free loan to the taxpayer in the amount of taxes delayed for 1 or more years.

Cash accounting facilitates do-it-yourself averaging by allowing the timing of payment of farm expenses and receipt of farm income. Thus, the taxpayer may reduce his marginal tax bracket and save on his total tax bill.

Often, the greater the marginal tax bracket on nonfarm income, the greater the benefit from liberal farm accounting rules and, thus, the greater the incentive to use farm investments to shelter nonfarm income from tax. In the above numerical example, had the nonfarm investor been in a 50-percent instead of a 70-percent marginal tax bracket, his tax profit would have been about \$10,500 instead of \$11,460.

Thus, the accounting rules allowed farm operations make it profitable for many nonfarmers to invest in agricultural enterprises. Whether the overall effect of this investment incentive is beneficial or detrimental to farmers is an open question. Inasmuch as needed equity capital and risk capital are provided by nonfarm investors, some farmers have benefited by being able to expand their operations and make fuller use of resources. For instance, many farmers have found it useful to sell some or all of their land and other assets to absentee investors and then rent back the farm assets for continued operation. Much of the land used for vegetable and fruit production in the United States is currently owned by absentee investors and leased to farmers for farm production. Other farmers have benefited by contracting with absentee investors who own breeding cattle and wish to place them on a farm for care and raising. In other cases, feeder cattle owned by absentee investors are placed on a contractual basis in feedlots owned and operated by farmers. The investment incentive for nonfarm capital entering agriculture would be substantially reduced without the current accounting rules allowed farm operations.

However, when many nonfarm investors purchase or operate farm enterprises for their tax benefits, the transactions can cause a distortion of the farm economy. The cash accounting rule and other provisions allow an individual to operate a farming enterprise at an economic break-even level or even at a loss and still realize an overall profit when the reduction in nonfarm taxes is considered. This could result in a competitive disadvantage to the farmer who depends mainly on the farm to provide the income to support him and his family. The farmer must compete in the marketplace for land, livestock, and other farm inputs with high-income nonfarm investors who, because of the tax advantages, may consider a farm profit, in the economic sense, unnecessary for their purposes.^{7/}

No published data are available on the number or extent of investments in agricultural enterprises made specifically for sheltering nonfarm income from

^{7/} Some farmers believe that competition from outside investors has adversely affected farmers' incomes. For example, in a 1971 survey of Missouri farmers to determine their opinions on various elements affecting farming, they were asked to rank four stated explanations for low incomes plus a fifth that they could write in. The four explanations were: (a) Too many farmers are trying to make a living in farming, (b) Farm programs do not limit acreages tightly enough, (c) Too many outside investors are moving into agriculture to get tax benefits, and (d) Farmers do not themselves engage in group action to affect prices they receive. Of 523 farmers who ranked these, item (a) received 6 percent of the first-choice votes, item (b) 4 percent, item (c) 38 percent, and item (d) 35 percent; 17 percent chose some other explanation. (Sadok Driss and Harold F. Breimyer, "Opinions of Leading Farmers about Farm Policy," in Economic and Marketing Information for Missouri Agriculture, Univ. of Mo., Dept. of Agr. Econ., Nov. 1971, p. 2.)

tax. However, there are statistics which show profit and loss by adjusted gross income (AGI) class for farm and nonfarm businesses reported on tax returns for 1970 (table 1). ^{8/} Table 2 shows the percentage of returns claiming net loss and the average loss by AGI class for farm and nonfarm businesses for 1970. ^{9/} These statistics indicate that business losses by individuals in the higher tax brackets were especially prevalent in the farm industry. There was a preponderance of farm losses over farm gains for high tax bracket taxpayers, indicating that, as people with farm income had more AGI, they tended to operate their farms at a loss. In contrast, the net profits of nonfarm businesses were higher than net losses through all income levels.

For individuals with farm operations, returns for those with AGI between \$50,000 and \$100,000 in 1970 showed farm profits of \$132 million and farm losses of \$139 million--nearly the same (table 1). Nonfarm business returns in this bracket showed profits of \$4,318 million and losses of \$112 million, a ratio of 38 to 1 in favor of profits. In the AGI class over \$100,000, returns showing farm operations reported farm profits of \$41 million and losses of \$122 million; the ratio of profits to losses was about 1 to 3. For nonfarm business returns in this class, net profits were \$1,162 million and net losses \$149 million, a ratio of profits to losses of about 8 to 1.

Table 2 indicates that the percentage of individuals claiming farm losses to offset their nonfarm AGI increased as AGI class increased. This occurrence of farm losses among high-income taxpayers indicates their use of the special accounting rules allowed farm operations.

In 1969, the U.S. Congress determined that the tax treatment of farm losses should be subject to tighter controls. ^{10/} It included in the Tax Reform Act of 1969 a provision requiring the establishment of an "excess deductions account" for taxpayers with nonfarm AGI over \$50,000 in which would be recorded the excess of farm losses over \$25,000. Gain on the subsequent sale of certain farm property would be treated as ordinary income rather than capital gain to the extent of balances in the excess deductions account. This requirement became effective for tax years beginning after 1969.

It is interesting that taxpayers otherwise subject to the excess deductions account can elect "to compute taxable income from farming by using inventories and by charging to capital account all expenditures...which are properly chargeable to capital account..." ^{11/} and thereby avoid the requirement to maintain an excess deductions account. In other words, the excess deductions account can be avoided by reporting farm transactions on an accrual basis, even though the tax-

^{8/} Internal Revenue Service, "Preliminary Report, Statistics of Income--1970 Individual Income Tax Returns," Washington, D.C., 1972, p. 29.

^{9/} Historically, 1970 was a favorable year for the average farmer in terms of total net income per farm. It was exceeded only slightly by 1969, a record year up to that time for farm net returns. (U.S. Dept. Agr., Econ. Res. Serv., "Farm Income, State Estimates," in Farm Income Situation, FIS 218 Sup., Aug. 1971, p. 11.)

^{10/} W. Fred Woods, "The Tax Reform Act of 1969: Provisions of Significance to Farmers," U.S. Dept. Agr., Econ. Res. Serv., ERS-441, Apr. 1970, p. 4.

^{11/} U.S. Statutes, Vol. 83, p. 567.

Table 1 --Profit and loss by AGI class reported by farm and nonfarm businesses, 1970 1/

AGI Class	Nonfarm businesses or professions				Farms			
	Net profit		Net loss		Net profit		Net loss	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount
	of	:(Million	of	:(Million	of	:(Million	of	:(Million
	returns	: dollars)	returns	: dollars)	returns	: dollars)	returns	: dollars)
Under \$5,000-----	1,329,540	2,672	441,803	1,476	798,924	1,170	481,766	1,267
\$5,000-\$10,000-----	1,388,114	5,568	384,623	488	546,192	1,717	380,627	600
\$10,000-\$20,000-----	1,407,131	8,946	385,779	471	351,464	1,784	283,241	470
\$20,000-\$50,000-----	594,074	10,896	95,865	233	84,420	863	63,603	276
\$50,000-\$100,000-----	95,941	4,318	13,203	112	9,064	132	14,647	139
\$100,000-\$500,000-----	14,867	1,116	5,603	114	2,151	39	4,988	104
\$500,000-\$1,000,000-----	235	31	282	25	56	2	208	9
Over \$1,000,000-----	77	15	117	10	19	--	90	9
Total-----	4,829,979	33,562	1,327,275	2,929	1,792,290	5,707	1,229,170	2,865

-- = Less than \$0.5 million.

1/ Gains from sales of livestock held for breeding purposes and of land with unharvested acres were not reflected in farm net profit or loss. AGI is adjusted gross income.

Source: Internal Revenue Service, "Preliminary Report, Statistics of Income, 1970 Individual Income Tax Returns," Wash., D.C., 1972, p. 29.

Table 2 --Percent of returns claiming net loss, and average loss, by AGI class, farm and nonfarm businesses, 1970 1/

AGI Class	Nonfarm businesses		Farms	
	or professions			
	Percent	Average	Percent	Average
	showing loss	loss (dollars)	showing loss	loss (dollars)
Under \$5,000-----	24.9	3,341	37.6	2,630
\$5,000-\$10,000-----	21.7	1,269	41.1	1,576
\$10,000-\$20,000-----	21.5	1,221	44.6	1,659
\$20,000-\$50,000-----	13.9	2,326	43.0	4,198
\$50,000-\$100,000-----	12.1	8,457	61.8	9,475
\$100,000-\$500,000-----	27.4	20,459	69.9	20,838
\$500,000-\$1,000,000---	54.5	87,404	78.8	42,663
Over \$1,000,000-----	60.3	87,436	82.6	103,867
Total-----	21.6	2,067	40.7	2,331

1/ AGI is adjusted gross income.

Source: Computed from table 1.

payer's nonfarm income and farm loss are high enough to place him under the requirement otherwise. 12/ This option indicates that the lawmakers recognized the accrual method as an appropriate means of accurately reporting farm transactions, but that the accrual method is such that it should not, as yet, be required of all farmers. We discuss the advantages and disadvantages of the accrual method in a later section.

Revoking the cash accounting option was one of the means suggested, but not actively pursued, in the 1969 congressional deliberations to combat the use of farm losses in sheltering nonfarm incomes from tax. 13/ It is sufficient to note at this point that because of its inability to accurately reflect yearly income and expenses, and because of the use of liberal farm accounting rules being made by nonfarm investors, the cash accounting option could conceivably be revoked, either in total or in part. Cash accounting for farmers came into being in 1915 by "administrative ruling." In many cases such as this--that is, when a provision has been in use by administrative ruling for so many years--it is not changed without congressional action.

FARMERS' USE OF CASH AND ACCRUAL ACCOUNTING

The Internal Revenue Service recently published figures indicating the number of farms, by type of farm, using cash and accrual accounting for 1968 (table 3). 14/ Only 2.7 percent of the 3,042,564 individual proprietors who filed farm tax returns for 1968 used accrual accounting (table 4); the other 97.3 percent used cash accounting. However, this 2.7 percent of returns represented 7.6 percent of the total farm business receipts reported for tax purposes that year. These percentages remained about the same for tax year 1969 (table 4).

Within the farm industries shown, the use of accrual accounting ranged from 0.6 percent for fruit, tree, nut, and vegetable farms to 7.6 percent for animal speciality farms. A higher percentage of livestock farmers used the accrual method than did crop farmers. In numbers, livestock farms comprise almost 68 percent of all accrual farms and these farms reported over 76 percent of all accrual farm receipts.

It is evident from these statistics that the accrual method is not widely used by farmers in reporting income for tax purposes. In the next section, we discuss some of the reasons why.

GENERAL COMPARISON OF CASH VERSUS ACCRUAL ACCOUNTING 15/

A farmer makes his choice of accounting method when filing his first tax

12/ W. Fred Woods, op. cit., p. 4.

13/ For example, see written testimony by Charles Davenport in Hearings before the Committee on Finance, U.S. Senate, on H.R. 13270, pts. 1-7, 91st Cong., 1st sess., Sept. 1969, pt. 4, pp. 3,526-3,532.

14/ Internal Revenue Service, "Statistics of Income--1968 Business Income Tax Returns," U.S. Govt. Ptg. Off., Wash., D.C., Pub. 438 (1-72), 1972, p. 21.

15/ This section draws liberally from the following sources: R. N. Weigle et al., "Income Tax Management for Farmers," North Central Regional Pub. No. 2,

Table 3 --Farm proprietorships: Total receipts, deductions, and profits, by accounting method and farm industry, 1968
(Money amounts in thousands of dollars)

Accounting method, item	: : All farms :	: : Field crop : farms :	: : Fruit, tree: : nut, and : : vegetable : : farms : :	: : Livestock : : farms : :	: : Animal : specialty : : farms : :	: : Other farms : : :
All farms:	:	:	:	:	:	:
Number of farms-----	3,042,564	1,200,523	139,942	1,470,833	57,303	173,963
Farm receipts-----	35,017,457	10,980,912	1,907,282	21,143,282	215,539	770,442
Total deductions-----	31,892,608	9,275,865	1,770,911	19,711,386	318,557	815,889
Net profit (less loss)-----	3,124,849	1,705,047	136,371	1,431,896	1/ 103,018	1/ 45,447
Cash basis farms:	:	:	:	:	:	:
Number of farms-----	2,961,067	1,186,225	139,123	1,415,670	52,936	167,113
Farm receipts-----	32,353,803	10,555,826	1,856,747	19,107,672	189,683	643,875
Total deductions-----	29,362,856	8,903,087	1,724,309	17,759,284	281,512	694,664
Net profit (less loss)-----	2,990,947	1,652,739	132,438	1,348,388	1/ 91,829	1/ 50,789
Accrual basis farms:	:	:	:	:	:	:
Number of farms-----	81,497	14,298	819	55,163	4,367	6,850
Farm receipts-----	2,663,654	425,086	50,535	2,035,610	25,856	126,567
Total deductions-----	2,529,752	372,778	46,602	1,952,102	37,045	121,225
Net profit (less loss)-----	133,902	52,308	3,933	83,508	1/ 11,189	5,342

1/ Net loss exceeds net profit.

Source: Internal Revenue Service, "Statistics of Income--1968 Business Income Tax Returns," U.S. Govt. Ptg. Off., Wash., D.C., 1972, p. 21.

Table 4 --Farm proprietorships: Percentage of farm numbers and business receipts, by accounting method and farm industry, 1968 and 1969

	1968						
Accounting method	All farms	Field crop farms	Fruit, tree nut, and vegetable farms	Livestock farms	Animal specialty farms	Other farms	1969, all farms
Percent of farms using:							
Cash method-----	97.3	98.8	99.4	96.2	92.4	96.1	97.4
Accrual method----	2.7	1.2	0.6	3.8	7.6	3.9	2.6
Percent of business receipts represented by:							
Cash method-----	92.4	96.1	97.4	90.4	88.0	83.6	92.5
Accrual method----	7.6	3.9	2.6	9.6	12.0	16.4	7.5

Source: Calculations from table 3 for 1968 figures and unpublished Internal Revenue Service figures for 1969.

return. He must continue using the method chosen unless he obtains written consent to change from the Internal Revenue Service.

The Cash Method

When income tax returns are filed according to the cash method, gross farm income includes the following: (1) Income actually or constructively received from the sale of all crops and market livestock produced on the farm, (2) profits (selling price less cost) on livestock and other items purchased for resale (purchase costs are not deductible until the year animals are sold), and (3) other farm income actually or constructively received, including payments for custom work, dividends, agricultural program payments, gasoline tax refunds, and so forth.

Allowable deductions include: (1) Farm operating expenses (including expenses which would otherwise be considered as capital in nature) paid during the year regardless of when incurred, and (2) depreciation expense allowable on farm improvements, machinery, equipment, and purchased dairy, breeding, sporting, and work animals.

Among the advantages of the cash method over the accrual method are that: (1) It allows a simple method of reporting, and fewer records are necessary as inventory accounts are not needed; (2) taxes are postponed in periods of year-to-year increases in inventory; (3) more flexibility is provided in adjusting net income from year to year; and (4) sales of raised capital assets may result in a lower tax liability.

The Accrual Method

When income tax returns are filed according to the accrual method, gross farm income includes the following: (1) All income from sales made during the year 16/ regardless of when payment is received, (2) all miscellaneous income regardless of source, and (3) the value of all livestock, crops, and supplies included in inventory at the end of the year.

Allowable deductions include: (1) The value of all livestock, crops, and supplies included in inventory at the beginning of the year, (2) the cost of livestock or products purchased during the year and included in inventory, (3) all operating costs or expenses incurred during the taxable year, and (4) depreciation (same as allowable under the cash method).

Some advantages of the accrual method over the cash method are that: (1) Farmers caught with 2 years of production sales in 1 year can level out their income by offsetting it with production included in the beginning and ending inventories; (2) if they wish, farmers can keep income and taxes on a more current basis if deductible expenses are expected to exceed receipts and little off-farm

Univ. Wisc., rev. 1970; John C. O'Byrne, Farm Income Tax Manual, 3rd ed., The Allen Smith Co., Indianapolis, Ind., 1964; and Internal Revenue Service, "Farmer's Tax Guide, 1972 Edition," Pub. 225.

16/ However, see our later discussion on the use of a capital account under the accrual method.

income is available against which to offset this loss; and (3) social security benefits may be increased.

Comparison of Methods

The following example illustrates the difference in handling expenses and receipts for income tax purposes under the two methods: Suppose a farmer purchases and takes delivery of feed for \$500 on December 15 and charges the purchase. He is billed for it in January and pays the bill then. Under the cash method, the feed is considered a farm expense in January when the bill is paid. Under the accrual method, the \$500 expense is a deduction in December when the obligation to pay was incurred. Feed on hand at the end of the year would be included in the ending accrual inventory.

Under the accrual method, increases in inventories are counted as income. For example, suppose a farmer raises and feeds livestock during the year but does not sell any. With the cash method, he has no income until payment for the livestock is actually received. Under the accrual method, there is income in the amount of any increase in the value of livestock and crops on hand at the end of the year compared with the value at the beginning of the year.

Cash accounting has advantages for the farmer who is expanding his assets and trying at the same time to achieve an adequate net income. Cash accounting allows him to postpone some of his tax obligations on inventory increases and frees cash for use in high-payoff working capital. However, when the growth stage is over, the delayed taxes tend to "catch up" with the farmer. This is because many items used as deductions to reduce taxes tend to decline (for example, interest payments, depreciation, and investment credit).

SPECIFICS OF THE ACCRUAL METHOD

The accrual method involves the keeping of inventories. An inventory for tax purposes includes two items--a physical count and a valuation. Both may be difficult to obtain under certain circumstances, but should be relatively simple for most farmers.

The Physical Count

Farm records should show the year-end inventory by actual count or measurement. The inventory should include all unsold items--whether raised or purchased--that are held for sale or for use in the farming operation. These include livestock held primarily for sale, feed, seed, and supplies (unless only small amounts are on hand). Livestock held for draft, dairy, breeding, or sporting purposes, whether raised or purchased, must either be included in inventory or be capitalized and depreciated (if subject to depreciation).

If farm assets are extensive and spread out over a large area, the physical count or measurement may be burdensome. In some cases, such as when counting livestock on a ranch covering several thousand acres in forested or hilly terrain or determining the number of bushels of grain in several storage bins, an accurate inventory may be impossible. However, to obtain a close approximation

of quantities, a yearly physical count is not always necessary. For instance, if accurate records during the year indicate quantities received and removed from the business, the physical count can be closely approximated. This practice is consistent with inventory accounting practices used by many nonfarm businesses.

The Inventory Valuation

Four methods of determining the value of the inventory at the end of the taxable year are available to the farmer:

(a) The Cost Method

Under this method, items are valued at the actual cost of producing them. Purchased items are valued at the actual purchase price plus any additional costs incurred between purchase and inventory time that add to the value of the item. This method requires the allocation of individual costs to each item included in the inventory. It is unworkable with certain farming enterprises. For example, it is difficult to allocate feed and other costs to animals in inventory versus animals in the capital account, when both sets of animals "eat at the same trough."

(b) The Lower of Cost or Market Method

For each inventory item, its value as determined by the cost method is compared with the current cost of replacing the item by purchase. The lower of the two is used as the inventory value. The current cost of replacing an item is the current bid price at the inventory date for items of like grade or quality in the quantity usually purchased.

(c) The Unit-Livestock-Price Method

Under this method, livestock are grouped or classified according to kind and age, and a standard unit price is used for each animal within a class or group. This method recognizes the difficulty of establishing the exact costs of producing and raising each animal. The unit prices assigned should reasonably approximate the normal costs incurred and are subject to approval by the Internal Revenue Service should the return be examined. Once established, the unit prices cannot be changed except with the consent of the Service.

(d) The Farm-Price Method

Under this method, each item (whether raised or purchased) is valued at the market price less the estimated direct cost of disposition. Market price is the current price at the nearest market in the quantities usually sold. This is the most common method of inventory valuation used by farmers and requires the least effort.

Farmers are able to select the inventory valuation method which suits them best. But the consent of the Internal Revenue Service is generally required to change the valuation method.

SPECIFIC ACCOUNTING PROCEDURES UNDER THE ACCRUAL METHOD

Farmers have a choice of including in inventory or in capital account livestock held for draft, dairy, breeding, or sporting purposes. To claim depreciation on capital assets, the farmer must include them in a capital account. Even though an asset may be initially included in the inventory, the farm can transfer qualifying assets to the capital account. ^{17/} Thus, the accrual method of accounting may reduce, but not eliminate, the advantages provided by the capital gains provisions of the tax laws.

To further explain accrual accounting, it is useful to discuss how each of the following five classes of assets is treated under accrual accounting.

Nondepreciable Assets Purchased for Resale

This category includes mainly livestock purchased for feeding to heavier weights and expected to be resold. The entire purchase price as well as operating and feeding costs are deductible when incurred. These costs are offset by any sales during the year and by the closing inventory values of these assets.

Assets Raised and Held Primarily for Sale or Use in the Business

This category includes livestock, crops, and other produce raised. Costs involved in raising these assets are deductible when incurred. These costs are also offset by sales during the year and by the closing inventory values of remaining assets.

Assets Purchased and Held for Draft, Breeding, Dairy, and Sporting Purposes

These assets, if mature at the end of the year, can be excluded entirely from the inventory account and included in the capital (or depreciation) account. ^{18/} The farmer has the option of including them in the inventory (where depreciation is not allowed) or placing them in a separate capital account (where depreciation is allowed). If inventoried, the purchase price and all other costs incidental to the animals are deductible when incurred. These costs

^{17/} To take full advantage of the benefits provided by capital gains provisions, it is generally best to transfer assets from inventory into the capital account as soon as possible. Purchased livestock held for draft, dairy, breeding, or sporting purposes do not have to be included in the inventory, but can be recorded directly in the capital account. Raised livestock of this nature can be transferred to the capital account upon reaching maturity. Inventoried capital assets are required, in the year of their sale, to be removed from the beginning inventory and their capital gain is the increase in value since the last inventory.

^{18/} Under certain conditions, and if the farmer is consistent year after year, immature draft, dairy, breeding, or sporting animals may be recorded in the capital account. If these animals are bred by the end of the year, a good case can be established for their inclusion in the capital account. For instance, sows born early in the year can be recorded directly in the capital account. Otherwise, the animals can be transferred from inventory to the capital account at maturity.

are offset by sales during the year and by the closing inventory value of the assets. If inventoried capital assets are sold during the year, their capital gain is the difference between the sales price and the year's beginning inventory value. (The beginning inventory is reduced by the value of these capital assets sold during the year.)

If kept in the capital account, the purchase price is not currently deductible, but all other costs incidental to the animals can be deducted and depreciation can be claimed. When the capital asset is sold, some or all of the depreciation claimed is recaptured as ordinary income. 19/ Capital gain is sales price less depreciation recaptured less basis, where basis is the value upon entering the capital account minus depreciation allowed on the asset.

Assets Raised and Held for Draft, Breeding, Dairy, and Sporting Purposes

As with purchased capital assets, the farmer has the option of including mature animals in inventory or placing them in the capital account. 20/ If included in the capital account, the value at which they enter the account is their inventory value. Depreciation can be taken to the extent of this value. (This may be contrasted with the cash-basis farmer, whose raised livestock have a zero basis and therefore cannot be depreciated.) All costs incidental to the animals can be deducted in the year incurred. When sold, the capital gain and depreciation recapture provisions apply, as discussed above.

Other Depreciable Assets Acquired for Use in the Business

These assets are placed in the capital account and their initial acquisition costs are recaptured by depreciation. Again, capital gain and depreciation recapture provisions (as discussed above) apply.

CHANGING ACCOUNTING METHODS

This section discusses the present rules for changing from cash to accrual accounting and the likelihood of an increased tax obligation in the year of the changeover. 21/

19/ Gain from the sale of depreciable property is ordinary gain to the extent of some or all of the depreciation taken. The balance of the gain, if any, is capital gain, if the asset otherwise qualifies. In the year of sale of a capital asset, depreciation allowed to date is recaptured as ordinary income only to the extent that the depreciation allowed for that asset does not exceed its gross sales price less adjusted basis. Consequently, some depreciation may avoid recapture as ordinary income. (See Internal Revenue Service, Supplemental Schedule of Gains and Losses, Form 4797, pt. III.)

20/ However, if the unit-livestock-price method of inventory valuation is used, the farmer no longer has this option. Under this valuation method, raised animals must be kept in inventory until the year of sale. See footnote 18 concerning the treatment of immature animals.

21/ This section draws information from the following sources: Dept. of Treasury, Revenue Procedure 70-27, 1970-2 CB 509; Internal Revenue Code Sects. 481 and 446 and Treasury Regulations pertaining to them; and John C. O'Byrne, op. cit., pp. 30-33.

The current law requires the consent of the Commissioner of Internal Revenue before a change is made from the cash method to the accrual method, or vice versa. The consent will not be given unless the farmer and the Commissioner agree on adjustments necessary to reflect amounts not previously reported as income or deductions, to prevent doubling up or escape of items from tax. If these adjustments are such that the taxpayer would have an increased tax obligation, the increased income (as a result of the change) can be spread over a 10-year period. This averaging of income may reduce the tax load somewhat, or at least spread it over a period of time.

Among adjustments required for the year of the change from cash to accrual are:

(1) Inclusion in taxable income of

(a) Receipts accrued at the end of the previous tax year not previously reported,

(b) The amount of inventory at the end of the previous tax year, reduced by amounts paid for purchased items in such inventory but not previously deducted, and

(c) Prepaid expenses in the previous year which have been deducted;

(2) Inclusion of deductions for

(a) Expenses accrued in the previous year which were not previously deducted, and

(b) Amounts previously included in income and which, under an accrual method, would again be included as they accrue; and

(3) Any other item or amount of income or deduction not included in (1) or (2) which should be considered to prevent such item from being duplicated or omitted from the net amount of the adjustment.

In simpler terms, the basic purpose of the required adjustment is to include in income for the year of the change all previously untaxed farm wealth except appreciation in value of real estate. This means that farmers who have a large beginning inventory of unsold livestock or crop products for which deductions for their production have been made in previous years will generally have a larger tax burden for the year of the change from cash to accrual than would otherwise be the case.

If a farmer has a choice in the matter, he might well choose a year to change from the cash to accrual method when tax rates are low, inventories are low, or tax exemptions are high. Where a farmer knows in advance that he will sell a large part of his accumulated inventory, he might choose that year for the changeover, since his tax liability will be high on the cash basis anyway and his closing inventory will be low. Other regular provisions of the tax law, such as income averaging and net operating loss carryover, can be used to reduce any increased tax obligation for the year of the changeover. Also, timing

of purchases of machinery (and claiming additional first-year depreciation and investment credit) and of soil and water conservation expenses can reduce the tax obligation for the year of changeover.

If all farmers as a group were required to change from cash to accrual accounting, it is likely that some new rules would be needed to (1) expedite the agreement between individual farmers and the Commissioner as to the required adjustments and (2) reduce the sudden increased tax burden on farmers. Processing about 3 million agreements between farmers and their IRS district directors in a single year would be burdensome, if not altogether impossible.

EFFECTS ON FARMERS OF CHANGING TO ACCRUAL ACCOUNTING

As noted in the previous section, it is likely that additional income taxes would be required for many farmers for the year in which a change from cash to accrual accounting was made. The amount of the additional tax would depend on the size and type of farm as well as on the amount of tax exemptions available to the farmer.

Internal Revenue Service statistics 22/ for tax year 1970 show that, of the 3,021,460 individuals who filed farm returns, 874,411 returns were nontaxable and of the taxable returns, 872,015 claimed net losses from farming. The nontaxable returns and those returns showing losses represent about 58 percent of all 1970 farm returns. These two groups would have been subject to little or no additional tax, had a requirement been made in 1970 to change from cash to accrual accounting.

In yearly operations under the accrual method, a larger portion of the gain from the sale of draft, dairy, and breeding livestock may be treated as ordinary income (as opposed to capital gain) than might have been the case under the cash method. Under the cash method, if other requirements are met, the entire gain, above acquisition cost, from sales of draft, dairy, and breeding livestock is treated as capital gain (except that depreciation taken is recaptured as ordinary gain). However, under the accrual method, these animals must be inventoried until the year of maturity, then they may be recorded in a capital account. Any increase in value while in inventory is treated as ordinary income. Only the increase in value while in the capital account (or since the last inventory date if not in the capital account) is accorded capital gain treatment under the accrual system.

The divergence between the cash and accrual methods in the amount of farm assets qualifying for capital gains treatment is greatest for raised capital assets. For purchased mature capital assets, the capital gains treatment is identical for the cash and accrual methods, provided that under the accrual method the animal is recorded in the capital account rather than in the inventory. For this reason, the farmer under the accrual method desiring the most favorable capital gain treatment should record his capital assets in the capital account as soon as they are eligible.

22/ Internal Revenue Service, "Preliminary Report, Statistics of Income--1970 Individual Income Tax Returns," Wash., D.C., 1972, p. 29.

Thus, even under the accrual system, since farmers can record mature draft, dairy, and breeding animals either in the capital account or in the inventory, it is possible to claim deductions against ordinary income in 1 or more years previous to the ultimate year of sale of the capital asset. Operating expenses such as labor, interest, feed, supplies, breeding fees, veterinary costs, and gasoline are currently deductible for farmers regardless of accounting method.

The main detrimental effect of accrual accounting on farmers is the loss of the ability to delay tax on the increase in value of productive (noncapital) assets. Under accrual accounting, the increase in value for livestock raised or purchased and held for sale will be effectively reported as income--per their inclusion in the ending inventory--and used to offset any operating costs which may have accrued during the year. Under cash accounting, this increase in value would not have been reported as income until the year of sale of the asset. The result of changing to accrual is that taxes will be paid on a more current basis as the value of the assets increases, rather than being delayed until the year of sale of the assets.

Similarly, the value of crops raised but not sold by year-end will be reported in the closing inventory under the accrual method. This inventory value will offset costs of production claimed during the year. In this way, accrual accounting, as opposed to cash accounting, tends to even out the fluctuations in reported income from year to year. However, it does not effectively reduce fluctuations in income caused by changes in prices or production yields.

It has been argued that farmers often have considerable difficulty in keeping accurate accrual records and therefore should avoid reporting on the accrual basis unless they fully understand it and feel it will save them taxes in the long run. On the other hand, the cash-basis taxpayer seeking to minimize his taxes must assess the effect of every transaction on his income-tax liability. Often, he must try to shift income and expenses between current and future tax years. The result may be less than optimal market timing, with any tax saving possibly offset by the loss of an advantageous market. Under the accrual method, the timing of sales and purchases is less important for tax purposes, since transactions are offset by ending inventory values. The farmer on the accrual basis can devote full attention to making transactions at what he considers to be optimal marketing conditions with little worry of adverse tax consequences.

In addition to the issue of keeping accurate accrual records, a problem with accrual accounting frequently cited is the need to allocate costs among various enterprises on the farm or among products on hand and products sold. This problem is overstated, because the need to allocate costs occurs only if the farmer chooses to use the "cost" or "lower of cost or market" methods of inventory valuation. ^{23/} The "farm-price" method and the "unit-livestock-price" method are available to farmers and greatly simplify the valuation procedure.

^{23/} However, under any inventory valuation method except the "farm-price" method, if the animal is sold or transferred to capital account, the costs of raising the animal to maturity since its last inventory date may require determination, and appropriate adjustments may have to be made to the basis of the animal and to the beginning inventory value. See Internal Revenue Service, "Farmers' Tax Guide," 1972 ed., p. 37. Use of the farm-price method of inventory valuation requires no allocation of costs to particular animals and therefore may be the simplest to use.

UNITED STATES DEPARTMENT OF AGRICULTURE
WASHINGTON, D.C. 20250

OFFICIAL BUSINESS

PENALTY FOR PRIVATE USE, \$300

POSTAGE AND FEES PAID
U.S. DEPARTMENT OF
AGRICULTURE
AGR 101

FIRST CLASS

